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GLOBAL GUIDE 2017
PRIVATE EQUITY AND VENTURE CAPITAL

Private equity in Luxembourg: market and regulatory overview

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MARKET OVERVIEW

1. How do private equity funds typically obtain their funding?

Funds of funds were the largest contributor to fundraising in the French and Benelux regions in 2016. According to the 2016 European Private Equity Activity report of Invest Europe of May 2017, contributions to the total amount of funds raised in 2016 also came from the following sources:

- Funds of funds: 24%.
- Sovereign wealth funds: 9%.
- Pension funds: 20%.
- Government agencies: 6%.
- Family offices and private individuals: 14%.
- Corporate investors: 3.0%.
- Banks: 9%.

No numbers have been published yet with a purely Luxembourg focus for 2016.

Family offices play an increasingly important role in the fund raising process of most PE funds.

The main fund players in Luxembourg are private equity houses. Information is not publicly available for non-regulated vehicles. In relation to the geographical origin of initiators of mutual investment fund (*organismes de placement collectif*) in 2015 (the annual report of the CSSF for 2016 has not yet been released):

- US investors dominate with 22.45% of the market.
- 16.16% came from the UK.
- 14.68% came from Germany.
- 13.98% came from Switzerland.
- 8.21% came from Italy.
- 7.58% came from France.
- 4.56% came from Belgium.
- 2.31% came from Luxembourg.
- 2.14% came from the Netherlands.
- 1.70% came from Sweden.
- 6.23% came from other countries.

2. What are the current major trends in the private equity market?

Luxembourg is the leading private equity (PE) jurisdiction in Europe and the second largest global leader for domiciled funds after the US. Net assets under management in Luxembourg funds were EUR3,701,076 billion at the close of December 2016 (excluding assets held by SICARs). This represents an increase of 5.56% since 1 January 2016 (*CSSF Newsletter No. 194, March 2017*).

The Luxembourg Law of 12 July 2013 on Alternative Investment Fund Managers (AIFM Law), transposing the Alternative Investment Fund Managers Directive (AIFM Directive) was the opportunity to roll out a new regime for limited partnerships, matching the expectations of many investors familiar with common law partnerships set up in the UK, Delaware or the British Virgin Islands (BVI).

Since the AIFM Law, existing funds set up outside Europe have migrated to Luxembourg from offshore jurisdictions and the swift adoption by Luxembourg of the AIFMD swelled further assets under management in Luxembourg. With the implementation of the AIFM Directive, many Luxembourg funds were set-up with alternative investments funds managers (AIFMs) set up outside of Luxembourg benefitting from a passport to manage (regulated or unregulated) alternative investments funds (AIFs) in Luxembourg. The trend now is to set up Luxembourg-based AIFMs or use the services of third party Luxembourg-based AIFMs. The UK government triggered Article 50 of the Treaty of Lisbon at the end of March 2017, which could mean the end of Luxembourg PE funds being managed by UK-based AIFMs and/or UK PE funds (pending the negotiations between the EU and the UK). In relation to new fund raisings,the PE industry is planning for the worst, hoping for the best by using, for example:

- Parallel Luxembourg funds structures and/or terms permitting changes to existing UK-based AIFMs in favour of Luxembourg-based authorised AIFMs.
- Alternative structures with third-party Luxembourg-based AIFMs appointed to minimise the impact of the loss by UK-based AIFMs of passporting post-Brexit.

Non-UK major funds are also moving to Luxembourg, setting up a Luxembourg-based AIFM or increasing their presence to prepare for the implementation of the OECD base erosion and profit shifting initiative (BEPS) that requires increasing substance in Luxembourg.

The vast majority of PE funds are unregulated funds. The PE industry has a strong appetite for Luxembourg limited partnerships, a fund structure that is universally understood by investors. The AIFM Law profoundly reformed the common limited partnership (*société en commandite simple*) (SCS) and introduced the special limited partnership (*société en commandite spéciale*)

(SCSp) in the Luxembourg Act dated 10 August 1915 on commercial companies, as amended (Companies Act). The SCS and the SCSp are the structures of choice for PE. The SCS (as a Scottish limited partnership and a Delaware limited partnership) has separate legal personality. The SCSp (as an English limited partnership and a Cayman limited partnership) does not.

Despite the lack of legal personality, the assets contributed to the SCSp are registered in the name of the partnership and can only satisfy the rights of creditors that have been created in relation to the creation, running or liquidation of the SCSp. Therefore, the assets of the SCSp are not available to personal creditors of the general partners or the limited partners but only to creditors of the SCSp. In practice, 80% of PE funds are set up as unregulated funds, a vast majority of which are set up as an SCSp.

As for regulated funds considered by the PE industry, as of 31 December 2016 Luxembourg private equity regulated vehicles included (*CSSF's Newletter No. 194 of March 2017*):

- 283 risk capital investment companies (*sociétés d'investissement en capital à risque*) (SICARs).
- Some of the 1,639 specialised investment companies (*fonds d'investissement specialisés*) (SIFs).
- Since the law of 14 July 2016 on the reserved alternative investment fund (RAIF), sponsors who considered a SIF or SICAR as a main fund vehicle or feeder fund of an unregulated fund now very much favour a RAIF. This is because RAIFs avoid the over-layering of supervision (applicable to SIFs and SICARs) that came into existence with the law of 12 July 2013 on alternative investment funds managers. Their establishment is also much more expedient than regulated funds, as this is done without the regulatory licensing or oversight of the CSSF, while RAIFs provides favourable tax and legal regimes.
- RAIFs provide additional structuring solutions for AIFs in Luxembourg, with supervision through the AIFM. Further, no legal constraints apply to the statutory reserve for funds set up with a corporate form. There is also no restriction on dividend distributions and the redemption of shares. Those funds will not be required to consolidate the intermediary holding companies with the funds.
- As at the end of April 2017, 82 RAIFs were already registered at the Luxembourg trade and companies register.

3. What has been the level of private equity activity in recent years?

Fundraising

2015 and 2016 were successful years for fundraising, with a few new players on the market set-up by initiators spinning out of well-known houses to set their fund. There is a vast array of choices for limited partners to invest in new funds, although the number of funds closed last year was slightly less than in 2014 (2015: 1125 funds with, in aggregate, US$550.4 billion raised; 2014: 1368 funds with, in aggregate, US$551 billion raised). In practice, it is very difficult to provide an accurate estimate for the time needed to raise funds, which varies significantly depending on the characteristics of the fund, the track record of the initiators, commitment sizes, the limited partners' familiarity with the model of the fund, the investor's appetite for investing in a particular region, as well as other variables.

Investment

The level of activity in relation to investments by regulated vehicles (*see Question 6*) is as follows, based on the CSSF Annual Activities Report 2014:

- **Risk capital investment companies (*sociétés d'investissement en capital à risque*) (SICARs).** Based on the provisional figures as at 31 December 2014, the capital commitments of investors in SICARs totalled about EUR20.8 billion. The SICARs' total balance sheet was EUR34.2 billion.
- **Undertakings for Collective Investments (UCIs).** This includes specialised investment companies (*fonds d'investissement specialisés*) (SIFs). Net assets in non-listed transferable securities and venture capital totalled EUR10.87 billion and EUR0.94 billion respectively, as at December 2013.

There are presently no overall statistics relating to the volume of activity of non-regulated funds (*see Question 6*). Based on the statistics published by the European Private Equity & Venture Capital Association (EVCA), the number of companies financed and amounts injected in companies between 2012 and 2014 by PE funds and CV funds were as follows:

- PE: EUR28 billion in 2012 and 2013 and EUR30 billion in 2014, in less than 1,000 companies in each calendar year.
- VC: EUR3 billion in 2012, 2013 and 2014, in less than about 3,000 companies each calendar year.

2015 was generally a strong year for European PE deal activity, but there was a slight fall in the number of deals compared to 2014. In 2015, PE activity was noteworthy in Luxembourg due to the number of PE sponsors based in Luxembourg and the vast number of acquisition special purpose vehicles based in Luxembourg, which are as follows:

- 3,556 deals took place in 2015, in line with the average number of deals since 2011 (on average, 3,660 per year).
- 2015 saw a strong increase in deal value compared with 2014 (an aggregate amount of US$411 billion), showing a continued increase for the last four years, but this level remains far behind 2007 (US$694 billion).

The investment strategies followed by SICARs as at 31 December 2014 were as follows (*Commission for the Supervision of the Financial Sector* (*Commission de Surveillance du Secteur Financier*) (*CSSF*) *Annual Activities Report 2014*):

- Buy, build and sell investments: 208.
- Investments through buyout instruments: 38.
- Investments through mezzanine instruments: 19.
- Investments by risk capital funds in early stage investments: 123.

With sector-based distribution, 184 entities preferred not to limit their investment policy to a particular investment sector. Among the entities having adopted a specialised policy, there is a certain concentration in the real estate, energy, technology and services sectors.

SICARs' net assets, according to the main investment policy, were as follows (*CSSF's annual activities report 2014*):

- PE: EUR23.1 billion.
- VC: EUR8.2 billion.
- Mezzanine: EUR3 billion.
- Public-to-private: EUR0.1 billion.

In addition, specialised investment companies (*fonds d'investissement specialisés*) (SIFs) include a considerable number of vehicles investing in clean technologies, infrastructure projects and tangible assets such as art, wine, jewellery and similar assets.

Transactions

2015 was a good year for European PE deal activity, with fewer deals but a strong increase in value. Equally, the early part of 2016 was positive. However, Brexit triggered a challenging environment for investors that will last for some time, particularly for sterling denominated funds. This will not be an issue for investments in the UK, but the impact of the UK's decision to leave the EU has, and will continue to have in the short to medium term, an impact on existing portfolio companies and pending deals (although there will also be opportunities stemming from Brexit).

There is an unprecedented amount of liquidity for investments by private equity firms, which makes competition for assets intense. Firms must keep pace with investments as income is generated both by management fees and investments. Luxembourg has therefore had much activity in 2017 as many acquisition structures flow through Luxembourg and many funds are based in Luxembourg. The global amount of dry powder exceeded US$1.14 trillion (according to Preqin) in 2016. However, the European economic landscape remains challenging, prices are high for European assets and the European regulatory landscape remains uncertain.

Categories of investments have not changed significantly:

- Growth investments totalled:
  - EUR4 billion in 2012 and 2013;
  - EUR5 billion in 2014.
- Buyouts investments totalled:
  - EUR28 billion in 2012 and 2013;
  - EUR30 billion in 2014.
- Venture capital totalled EUR3 billion for each of these years.

In 2014/2015:

- A total of 2,416 European companies were exited representing former equity investments of EUR37.8 billion.
- The most prominent exit routes by amount were:
  - trade sale: 26.5%;
  - sale to another private equity firm: 24.3%;
  - sale of quoted equity: 10%. Almost 40% of all the divested companies followed these exit routes.

Exits

2015 was perceived locally as the year of big deals, with a widespread geographical cover. PE backed exits in 2015 surpassed the excellent records of 2014 for European buyout exits, with trade sales being at the core of the largest exits. Exits were dominated by corporations, with a slight reduction of IPOs and secondary buyouts.

REFORM

4. What recent reforms or proposals for reform affect private equity in your jurisdiction?

Two major reforms were very favourable for the PE industry in 2016:

- The law of 13 July 2016 improves the law on commercial companies of 10 August 1915 and modifies the Civil Code confirming practices which were used with a health warning due to the uncertainty of the law on these questions. Since 13 July 2016, the board or the general partner can suspend the voting rights of shareholders failing to comply with their obligations. A company may also issue tracking shares, and clauses providing for restrictions on transferability of shares are now formally recognised. In addition, a new form of company, the simplified public limited company, has been introduced into the Luxembourg legal system and it offers far more flexibility to its shareholders and managers than the public limited company. Among the many innovations adopted by this reform is the introduction of a new corporate entity, the *société par actions simplifieés* (SAS), which enables promoters to design their own set of governance rules and could serve as a holding company for private equity investors.
- The law of 14 July 2016 on the reserved alternative investment fund (RAIF), is an important and much needed reform as it tackles the over-layering of supervision that came into existence with the law of 12 July 2013 on alternative investment funds managers. It also facilitates the processes of establishing regulated funds (SIFs, SICARs and FCPs), as this will be done without the regulatory licensing or oversight of the CSSF and provides favourable tax and legal regimes.

Uncertainty as to what the regulatory environment will look like following the Brexit negotiations affects many Luxembourg AIFs currently managed by authorised UK-based AIFMs. Progress on a third-country passport is certainly out of reach since the vote on Brexit. Further, uncertainty over existing Luxembourg funds managed by UK-based AIFMs, and current fundraisings of Luxembourg funds, raises the question of what will happen to Luxembourg funds with managers who do not have to comply with the AIFMD, either because they are regulated outside the EU, or because they operate in the EU but are too small to be within its scope. The current picture is that managers actively fundraising must comply with national rules in each of the countries in which they want to market their fund (unless they are managing the fund within the EU and either qualify for the venture capital passport under Regulation (EU) 345/2013 on European venture capital funds (EuVECA,) or "opt-in" to full compliance with the AIFMD. These national private placement rules (NPPRs) are not easy to navigate, and compliance burdens range from relatively light to almost impossible. There is a risk that the EU turns inwards and adopts a more protectionist stance, especially as it contemplates what future access to give the UK.

All portfolio managers should review their policies and procedures to ensure that, following the implementation of MiFID II on 3 January 2018, all marketing materials and other communications to be made to clients and potential clients will be reviewed to ensure compliance with the MiFID II requirements before they are sent. Communications to all client categories will need to comply with the "fair, clear and not misleading" rule. However, the most significant change is that MiFID II extends to professional clients, whereas most of the specific requirements under MiFID I only apply to retail clients. Firms that confine their client base to professionals and have previously been able to ignore many of the more detailed and prescriptive rules are likely to find that they need to do a great deal of additional work to ensure they can comply from 3 January 2018.

TAX INCENTIVE SCHEMES

5. What tax incentive or other schemes exist to encourage investment in unlisted companies? At whom are the incentives or schemes directed? What conditions must be met?

Incentive schemes

Luxembourg non-regulated vehicles benefit from several tax incentives. These are generally available to all Luxembourg resident companies (irrespective of their underlying investments or the nature of their shareholders).

Specialised investment fund

The specialised investment fund is not subject to tax, apart from a registration tax (*taxe d'abonnement*) of 0.01% on the net asset value per annum, which is, itself, subject to certain exemptions.

Participation exemption regime

This regime applies to a financial interest holding company and is subject to Directive 2014/86/EU and Directive 2015/121/EU implementing new EU anti-abuse provisions in Parent-Subsidiary Directive (2011/96/EU) as transposed and into force in Luxembourg since 1 January 2016 and provides that if certain holding thresholds (percentage or value) are fulfilled, dividend payments and capital gains are tax exempt. In addition, Luxembourg has a far-reaching network of treaties avoiding double taxation.

Taxation of RAIFs

A Revolution in the Alternative Investment Fund (RAIF) that invests in risk capital and that is not a mutual fund (*fonds commun de placement*) (*FCP*) will be subject to a tax regime similar to the one applicable to SICARs as provided below:

- The RAIF will be fully subject to corporate income tax and municipal business tax (unless it is established as an SCS or SCSp in which case, as a transparent entity, it will be as a rule exempt from corporate income tax and municipal business tax) but income and gains derived from securities will be exempt.
- It will be exempt from net wealth tax, except for the minimum net wealth tax amounting, in most cases, to EUR4,815 (since 2017) which replaces the minimum corporate income tax as from 1 January 2016 (unless it is established as an SCS or SCSp in which case it will also be exempt from this minimum net wealth tax).
- The management of RAIFs is VAT exempt in Luxembourg.
- Its distributions will generally not be subject to any withholding tax and must not be subject to Luxembourg taxation in the hands of non-resident investors.

The OECD released the final reports on the 15 Actions of the Base Erosion and Profit Shifting Project (BEPS) which aims at addressing double non-taxation as well as double taxation issues in the global economy, which impact on venture capital firms' returns on investments. The BEPS project will be partly implemented into the domestic legislation of all EU member states as from 2019 with the entry into force of Directive (EU) 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the internal market (Anti-Tax-Avoidance Directive), as amended, dealing with hybrid mismatches, interest deduction limitation, controlled foreign corporations, exit taxation and a general anti-abuse rule. The OECD is currently dealing with treaty-shopping. This enables an investor to take advantage of a tax treaty by investing into a portfolio company through an intermediate jurisdiction, and thereby getting an advantage which would not be available had the same investor invested directly. A further step should be taken in this respect with the signing of the multi-lateral instrument (MLI) in June 2017. More than 100 jurisdictions have concluded negotiations on the MLI that will transpose results from BEPS into more than 2,000 tax treaties worldwide. The MLI will implement minimum standards to counter treaty abuse and to improve dispute resolution mechanisms, while providing flexibility to accommodate specific tax treaty policies and allowing states to strengthen their tax treaties with other tax treaty measures developed in the BEPS Project.

Funds tend to pool investors from a range of countries, for obvious commercial reasons, and not to take advantage of tax treaties. However, the OECD's concern is that a fund might include investors who would not be entitled to the benefit of a tax treaty if they invested directly. If funds are not carved out, then many investors might be in a worse position, or fund managers would be subject to a significant compliance cost in differentiating between the two types of investors.

At whom is it directed

These tax incentives are directed at Luxembourg holding companies (*sociétés de participations financière (Soparfis)*) and are available irrespective of the nature of the investors and the underlying investments.

Conditions

See above, *Incentive schemes*.

FUND STRUCTURING

6. What legal structure(s) are most commonly used as a vehicle for private equity funds in your jurisdiction?

Non-regulated vehicles

Special limited partnerships, common limited partnerships (LPs) and *soparfis* are non-regulated vehicles that have the object of holding and financing participations in portfolio companies.

By far the most commonly used forms of non-regulated vehicles are the special limited partnership (*société en commandite spéciale*) (SCSp) and the common limited partnership (*société en commandite simple*) (SCS).There is a strong appetite for Luxembourg limited partnerships, due to their key features:

- **Confidentiality is guaranteed.** Registration of the SCS/SCSp at the Luxembourg trade and companies register (RCS) is minimal and includes their name, the name of their general partners (GPs), their object, their address and their duration. There is no publication of the performance of the SCSp and the SCSp's accounts are not filed at the RCS.
- **Safe harbour for actions by LPs.** In Delaware and the Cayman Islands, the scope of decisions made by limited partners without compromising their limited liability is uncertain. In Luxembourg, the Luxembourg act dated 10 August 1915 on commercial companies, as amended (Companies Act) introduced a non-exhaustive list of actions that may be taken by LPs, which do not, as such, put their limited liability at risk.
- **Wide choices for contributions.** Contributions to an SCS and SCSp can be made in kind, cash or industry, and can include loans granted to the partnership, with no debt-to-equity ratio to be complied with. A mere statement in the limited partnership agreement (LPA) by the partners suffices for non-cash contributions. Contributions, withdrawals, loans, allocations to profits, losses and expenses can be booked for each limited partner in a capital (and loan) account.
- **The GP and the LP's creditors cannot seize the SCSp's assets.** The assets contributed to the SCSp are registered in the name of the partnership and can only satisfy the rights of creditors that have been created in relation to the SCSp's business. The SCSp's assets are not available to the GPs or the LP's creditors.
- **High flexibility on power and economic distributions.** Limited or multiple as well as non-voting partnership interests (which may be represented by securities issued by the SCS/SCSp) are permitted, enabling investors to distribute powers as they deem fit in the LPA. In addition, there is no claw back on distributions in the case of insolvency, except for in the case of fraud.
- **Freedom to organise transfers of partnership interests.** The LPA organises all conditions relating to the redemption, transfer, splitting or pledge of their interests by the LPs. The Companies Act provides conditions for transfers if those transfers are not dealt with in the LPA. The Companies Act also provides that partnership interests can be listed on a stock exchange or a regulated market.

Other unregulated fund structures include:

- Private limited company (*société à responsabilité limitée*) (SARL). This is commonly used for investing in private equity, since it offers significant flexibility. The minimum share capital is EUR 12,000 and the number of shareholders is limited to 100.

- Partnership limited by shares (*société en commandite par actions*) (SCA). The SCA requires at least:
  - one general partner with unlimited liability being in charge of the management (*commandités*);
  - one limited partner with limited liability (*commanditaires*), who cannot be involved in the management of the SCA.

Its minimum share capital is EUR30,000. The rules applicable to public limited companies (*société anonyme*) (SA) generally also apply to SCAs. The SCA regime has been modernised by the Alternative Investment Fund Managers (AIFM) Law. When the SCS or SCSp are structures available to sponsors, these are now much preferred in comparison to the SCA (*see Question 4*).

Publiclimited companies (*société anonyme*) (SA). Its minimum share capital is EUR30,000. There is no restriction on the number of shareholders and its shares are freely transferable. The board of directors requires in principle at least three directors. It can also be listed.

However, Luxembourg has seen extensive use of the SCS and SCSp since the introduction of the AIFM Law (*see Question 4*).

Regulated vehicles

Conversion to RAIF. Since the law of 14 July 2016 on the reserved alternative investment fund (RAIF), many sponsors consider a RAIF instead of a regulated vehicle. This new law was a clear shift from a product approach to indirect regulation through the external authorised alternative investment fund manager (AIFM), while having the benefit of the EU passport in relation to the marketing of its interests, units or shares throughout the EU. It tackled the over-layering of supervision that came to existence with the implementation of Directive 2011/61/EU on Alternative Investment Fund Managers (AIFMD) in Luxembourg while streamlining the process to establish regulated funds in Luxembourg.

RAIFs combine the legal and tax features of regulated AIFs like specialised investment funds (*fonds d'investissement spécialisés*) (SIFs) or investment companies in risk capital (*société d'investissement en capital à risqué*) (SICAR) without the regulatory licensing or oversight of the Financial Sector Supervisory Commission (*Commission de Surveillance du Secteur Financier*) (CSSF), together with favourable tax and legal regimes.

Whether or not existing funds should become a RAIF requires a case-by-case analysis from tax, legal and regulatory perspectives. For example:

- Unregulated sub-threshold funds that cannot market in some jurisdictions and must appoint an authorised AIFM in any event, should consider closely the tax regime applicable to RAIFs for their conversion.
- Unregulated SCSs and SCSps may wish to benefit from an umbrella structure and benefit from a marketing passport, and SICARs, SIFs and FCPs may wish to benefit from the lighter requirements on redemptions.

In addition, the absence of a regulatory approval requirement allows managers to reduce the time to market their fund and reduces costs compared to other types of regulated fund vehicles. A RAIF is the structure of choice in comparison to Luxembourg regulated funds.

The assessment of whether a RAIF should be preferred to an unregulated fund structure very much depends on the initiator's key motivations.

RAIFs can be set up as one of the following corporate forms:

- SCS.
- SCSp.
- SCA.
- Co-operative (*société cooperative organisée sous forme de société anonyme*).
- SARL.
- SA.

These various possibilities offer significant contractual freedom.

Regulated funds. The following vehicles are supervised and authorised by the regulatory authority, the Commission for the Supervision of the Financial Sector's (*Commission de Surveillance du Secteur Financier*) (CSSF) (www.cssf.lu).

Risk capital investment companies (*sociétés d'investissement en capital à risque*) (SICARs) were implemented to offer a new lightly regulated vehicle for investment in private equity to well-informed investors (*see Question 10*). It combines a flexible corporate structure for investing in risk capital, with the benefits of light supervision by the CSSF and a neutral tax regime.

SICAR is an optional regime, and must be formalised in the object clause of the company's articles of association. SICARs can be incorporated as one of the following companies:

- SCS.
- SCSp.
- SCA.
- Co-operative (*société cooperative organisée sous forme de société anonyme*).
- SARL.
- SA.

These various possibilities offer significant contractual freedom. While general corporate law provisions apply to SICARs, they have substantial flexibility in determining their articles of association:

- The share capital of the SICAR must be at least EUR1 million. This minimum must be subscribed to within one year of incorporation and paid up in principle at least up to 5% of the capital, including share premium. It is also possible to opt for variable capital, whatever the corporate form, since the introduction of the (*SICAR Amendment Law*). This new development should attract more foreign investors familiar with the tax incentive vehicles of common law limited partnerships.
- Although SICARs are supervised by the CSSF (*see Question 10*), their reporting obligations are lighter than those of Undertakings for Collective Investments (UCIs), although they must prepare and publish annual accounts, and update the prospectus on the issue of additional shares. An independent auditor (approved by the CSSF) must audit the annual accounts. However, a SICAR is not required to publish a bi-annual report.
- Since the SICAR Amendment Law, there is no mandatory legal requirement to calculate the net asset value on a compulsory bi-annual basis. The net asset value must be based on the principle of fair value (similar to the SIF regime).
- SICARs must invest in risk capital and have no obligation of investment diversification (unlike UCIs). Therefore, SICARs can invest all of their funds in a single company or project. A SICAR can also be structured as an umbrella vehicle with separate compartments enabling it to run different investment policies in each compartment.
- The duty of the custodian is the same as for specialised investment companies (*fonds d'investissement specialisés*) (SIFs) (that is, its monitoring duty is restricted to the general safekeeping of the assets).

SIFs. SIFs are subject to lighter statutory rules than other UCIs. The following can create or invest in a SIF (*see Question 12*):

- Institutional investors.

- Professional investors.
- Other well-informed investors (whether legal or physical persons).

The SIF aims to be an attractive vehicle through its flexible functioning rules, and the extensive scope of assets open to investment. A SIF can be used to invest in any kind of assets without limitation, to the extent it complies with the general risk spreading rules (*see Question 13*). It is authorised and supervised by the CSSF and has a neutral tax regime. A SIF can be created as:

- A common fund (*fonds commun de placement*) (FCP). This is a contractually drawn up set of jointly owned assets with no legal personality, managed by a Luxembourg management company.
- An investment company with a variable share capital (*société d'investissement à capital variable*) (SICAV), incorporated as any of the following:
  - SCA;
  - SCS;
  - SCSp;
  - co-operative;
  - SARL;
  - SA.
- A company with a fixed share capital (*société d'investissement à capital fixe*) (SICAF), which is incorporated as any of the following:
  - SCS;
  - SCSp;
  - SCA;
  - co-operative;
  - SARL;
  - SA;
  - unlimited company (*société en nom collectif*) (SNC);
  - civil company (*société civile*).

The legal provisions and types of companies under which a SIF can be incorporated allow investors to set up their own corporate governance rules in a flexible manner:

- The subscribed share capital (including share premium) must be at least EUR1.25 million, within 12 months of the date of CSSF approval. The shares need only be paid up to a minimum of 5%.
- SIF supervision and its reporting obligations are the same as for a SICAR as are the issuing document requirements (that is, information necessary for the investors to form their view on the investments proposed and its related risks). The SIF's issuing document must provide for the quantifiable limits to be complied with (*CSSF's circular 07/309 relating to the risk-spreading principle for the SIF*) (*see Question 10, Question 11 and Question 13*).

A SIF can be organised with several segregated sub-funds.

7. Are these structures subject to entity level taxation, tax exempt or tax transparent (flow through structures) for domestic and foreign investors?

Reserved alternative investment fund (RAIF)

A RAIF is subject to two different tax regimes, depending on whether it has opted for the special tax regime (*see below*):

- **General tax regime.** A RAIF, irrespective of its corporate form, is only subject to a tax regime similar to the one applicable to a SIF:
  - it is subject to subscription tax at a rate of 0.01% per year (with certain exemptions available);
  - it is exempt from corporate income tax, municipal business tax and net wealth tax; and
  - its distributions are generally not subject to any withholding tax**;**
  - Luxembourg taxation is in the hands of non-resident investors.
- **Special tax regime.** A RAIF that invests in risk capital and that is not a mutual fund (FCP) is subject to a tax regime similar to the one applicable to SICARs:
  - it is fully subject to corporate income tax and municipal business tax (unless it is established as an SCS or SCSp, in which case, as a transparent entity, it is as a rule exempt from corporate income tax and municipal business tax). However, income and gains derived from securities (*valeurs mobilières*) are exempt from these taxes;
  - it is exempt from net wealth tax, except for the minimum net wealth tax (unless it is established as an SCS or SCSp, in which case it is also exempt from this minimum net wealth tax); and
  - its distributions are generally not subject to any withholding tax and should not be subject to Luxembourg taxation in the hands of non-resident investors.

SICAR

The tax status of SICARs depends on the legal form chosen and these are discussed below.

SCS and SCSp are tax transparent and, therefore, not subject to tax in Luxembourg, except for municipal business tax if they perform or are deemed to perform commercial activities (*see Question 4*). Tax is levied at investor level, according to the law of where they are tax resident. Double tax treaties or EU directives may apply in the country of the investor and the country of the portfolio company, depending on the relevant regulations.

SICARs as corporations. They are in principle fully taxable in Luxembourg at 27.08% (2017 enacted tax rate; 26.01% as from 2018), including contributions to the employment fund and municipal business tax for the city of Luxembourg (this can vary slightly for other municipalities). They should in principle benefit from double tax treaties and the Parent-Subsidiary Directive, at least from a Luxembourg perspective. If a country does not recognise the SICAR, alternative structuring is available.

The tax regime applicable to SICARs incorporated as a corporation is as follows:

- Gains or income from transferable securities are not subject to tax.
- Income from cash arising from investment in risk capital is not subject to tax, subject to certain conditions.
- SICARs are not subject to net-wealth tax.

- SICARs are not eligible for the tax group regime (*see Question 5*).
- Distributions by SICARs are free of withholding tax.
- There is generally no tax in Luxembourg on the disposal of an interest in a SICAR by non-resident investors.
- Management services for these vehicles are exempt from VAT. SICAR are considered as VAT taxable persons but their activities are generally exempt from VAT. Therefore, they cannot in principle deduct input VAT. Active VAT strategy should therefore be implemented to mitigate VAT costs for these vehicles, notably on deal fees (for example, the use of a VAT exemption on certain services received, recharge of costs, and so on).
- SICARs are subject to a fixed annual fee of EUR1,500 and a registration fee of EUR1,500 (EUR2,650 for umbrella SICARs) payable to the Commission for the Supervision of the Financial Sector's (*Commission de Surveillance du Secteur Financier*) (CSSF).

SIF

SIFs are not subject to:

- Corporate income tax.
- Municipal business tax.
- Net-wealth tax. They are subject to a subscription tax on the net asset value (0.01%), which is calculated quarterly. The law allows some specific exemptions.

A SIF is subject to either:

- An annual fee of EUR1,500 (EUR2,650 for umbrella structures).
- A registration fee of EUR1,500 (EUR2,650 for umbrella structures).

SIFs formed as investment companies (*société d'investissement à capital fixe*) (SICAFs) can benefit from double tax treaties. 49 double tax treaties currently apply to these vehicles and their application is generally complex and must be reviewed on a case by case basis. SIFs formed as common funds (*fonds commun de placement*) (FCPs) generally do not benefit from double tax treaties but could access few.

Management services for these vehicles are exempt from VAT. SIFs are considered as VAT taxable persons but their activities are generally exempt from VAT. Therefore, they cannot in principle deduct input VAT. Active VAT strategy should therefore be implemented to mitigate VAT costs for these vehicles, notably on deal fees (for example, use of VAT exemption on certain services received, recharge of costs, and so on).

The following tax treatment applies:

- **Domestic investors.** Income received by both individuals and corporate domestic investors from SIFs is taxable under the usual tax rules. Capital gains realised by individual investors are taxable if the sale occurs less than six months following the purchase of the units and the seller holds more than 10% of the SIF.
- **Foreign investors.** No Luxembourg tax applies. Income derived from a SIF is taxed in the country where the investors are resident.
- **Non-regulated vehicles (*Soparfis*).** See*Question 6.*

VAT exemption applicable to the management of AIFs

Under current Luxembourg VAT legislation, the management of AIFs benefits from a VAT exemption. The Luxembourg VAT legislation was amended by the AIFM Law to specifically cover AIFs in the VAT exemption regime. The VAT exemption applies, in principle, to administration, portfolio and risk management services rendered to a fund. Services delegated to a third party may also benefit from a VAT exemption. VAT exemptions are, however, interpreted strictly and in the light of Luxembourg and European case law. A case-by-case analysis is advisable.

8. What (if any) structures commonly used for private equity funds in other jurisdictions are regarded in your jurisdiction as being tax inefficient (whether by not being recognised as tax transparent or otherwise)? What alternative structures are typically used in these circumstances?

The use of a foreign structure is unlikely as Luxembourg is typically used as a platform for holding and acquisition vehicles in operating groups, either in Luxembourg itself or abroad. The features of Luxembourg as a holding location are equally strong for Luxembourg targets as for foreign targets. Therefore, it is unlikely that foreign holding vehicles would be set up to acquire a Luxembourg group.

Foreign investment vehicles commonly used for private equity funds in other jurisdictions would generally be tax transparent (subject to review on a case-by-case basis) in Luxembourg, such as:

- UK Channel Islands limited partnerships.
- Caribbean alternative investment vehicles.
- Delaware limited liability companies.

FUND DURATION AND INVESTMENT OBJECTIVES

9. What is the average duration of a private equity fund? What are the most common investment objectives of private equity funds?

Duration

Despite the recent trend in the market for longer term funds, in the large buyout space the vast majority of funds are still ten years, either from the first or final closing date. There are then typically two possible extensions of one year each. In some cases the first extension can be at the manager's discretion, but in the vast majority of our sample both extensions either require advisory board consent or often an investors' 50% consent.

Investment objectives

The main objective of private equity (PE) funds is to have the highest return on capital possible at the time of the exit (capital gain) and a seamless repatriation without tax leakage. Return is usually measured by the internal rate of return (IRR) achieved by the fund over its life cycle. Closed-ended PE funds have a life cycle of eight to 12 years. Some PE funds are evergreen. PE investors usually expect an average annual IRR of 20% to 25%. The volume of equity bridge financings has increased considerably because, in the current market conditions, they boost the IRR of funds.

FUND REGULATION AND LICENSING

10. Do a private equity fund's promoter, principals and manager require authorisation or other licences?

Whether the management bodies require Commission for the Supervision of the Financial Sector's (*Commission de Surveillance du Secteur Financier*) (CSSF) approval depends on the type of investment vehicle used.

The Luxembourg Law of 12 July 2013 on Alternative Investment Fund Managers (AIFM Law) imposes new requirements on Luxembourg based alternative investment fund managers (AIFMs), which must now be authorised by the CSSF when managing assets acquired with leverage in the fund of EUR100 million or more, or assets under management with no leverage in the fund of EUR500 million or more. These requirements include, among other things:

- The obligation to retain eligible conducting officers.
- The enhancement of the central administration and substance of the structure.
- The necessity to introduce rules or policies on risk management, compliance, internal audit, transparency, remuneration and conflict of interest situation.

The CSSF is also the competent authority for approving risk capital investment companies (*sociétés d'investissement en capital à risque*) (SICARs) and specialised investment companies (*fonds d'investissement specialisés*) (SIFs), and specifically requires the following:

- SICAR or SIF directors and managers must prove their ability to perform their duties. The AIFM Law implies changes in this respect (*see Question 4*).
- Constitutive documents to be produced (prospectus, issuing documentation, management regulations or articles of incorporation), which must comply with the applicable laws.
- The appointment of a custodian with whom the SICAR's or SIF's assets are deposited.
- The appointment of an independent auditor (for monitoring obligations, see *Question 6*).

There is no requirement for a promoter.

11. Are private equity funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions?

Regulation

Specialised investment companies (*fonds d'investissement specialisés*) (SIFs) and risk capital investment companies (*sociétés d'investissement en capital à risque*) (SICARs) are regulated entities, and are, therefore, subject to prior approval by the Commission for the Supervision of the Financial Sector's (*Commission de Surveillance du Secteur Financier*) (CSSF) before they are launched. These vehicles must issue a prospectus or issuing document, which is examined or approved by the CSSF (*see Question 14*). The central administration of the fund (bookkeeping, share registrar and transfer agent services) must be located in Luxembourg. RAIFs are supervised through the AIFM managing them.

Soparfis are non-regulated vehicles and therefore do not require regulatory approval. For the avoidance of doubt, this includes the limited partnerships. However, for those *Soparfis* whose equity can be offered to the public, a prospectus complying with the rules of the Law dated 10 July 2005 implementing Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading (Prospectus Directive) must be approved by the CSSF.

Exemptions from publishing a prospectus apply in some circumstances.

12. Are there any restrictions on investors in private equity funds?

Number of investors

A private limited company (*société à responsabilité limitée*) SARL must have a minimum of one shareholder and a maximum of 100.

A partnership limited by shares (*société en commandite par actions*) (SCA), a common limited partnership (*société en commandite simple*) (SCS) and a limited partnership (*société en commandite special*) (SCSp) must have a minimum of two shareholders (at least one unlimited partner, who often is the general partner, and one limited partner) with no maximum limit. The minimum required for an SA is one shareholder.

Type of investors

The investors in a SICAR, SIF or RAIF must be well-informed investors, which are any of the following:

- An institutional investor.
- A professional investor.
- Any other investor that:
  - confirms in writing that it adheres to the status of a well-informed investor;
  - invests a minimum of EUR125,000 or is certified by a credit institution, a investment firm or a management company as having expertise, experience and knowledge in adequately appraising an investment in the SICAR or in the SIF.

Managers and other persons who are involved in the management of a RAIF, SICAR or SIF are no longer required to certify their status as a well-informed investor to be an eligible investor. Furthermore, as for any fund, the manager is responsible for the compliance with anti-money laundering requirements for any investor in the fund it manages.

13. Are there any statutory or other maximum or minimum investment periods, amounts or transfers of investments in private equity funds?

There are no statutory or other limits on maximum or minimum investment periods, amounts or transfers of investments in SICARs and SIFs as well as in any unregulated fund vehicle. Any limits are subject to the contractual terms agreed by the parties themselves. The investments in a SICAR must be made for a certain period of time with the intention of a later sale at a profit. For a SICAR or a SIF, the Commission for the Supervision of the Financial Sector's (*Commission de Surveillance du Secteur Financier*) (CSSF) can also give some additional requirements for a specific investment policy. Risk spreading rules apply to RAIFs that both:

- Do not invest in risk capital.
- Are subject to the application of the special tax regime (*see Question 5, Taxation of RAIFs*).

While no specific rules are included in the RAIF Law, the position taken is to apply the diversification rules applicable to SIFs.

INVESTOR PROTECTION

14. How is the relationship between the investor and the fund governed? What protections do investors in the fund typically seek?

The prospectus or issuing document and the articles of association or management regulations regulate the relationship between the investors and the fund. No "best practice" guidance is published in Luxembourg.

The main aim of the prospectus or issuing document is to protect the investors by giving them information on the nature of the investments to be made. Among other provisions, the prospectus states the rules relating to:

- The investment strategy.

- Distributions.
- Information rights.
- Key man provisions.
- Fees, expenses and the remuneration policy.
- Commitments.
- Exit.
- Divorce.
- Carried interest.
- Hurdle rates.

Regarding key investor protections trends, with no fault provisions, voting thresholds are usually 75%, whereas for fault provisions only a simple, or occasionally two-third, majority is typically required. The pendulum tends to swing in favour of investors in relation to no fault removal provisions. A key feature of the investor protections is the treatment of carried interest following removal of the general partner or termination of the fund. In the overwhelming majority of cases, general partners are permitted to retain all the carried interest from investments made prior to the no fault event. On a fault removal or termination, the carried interest treatment is generally much more investor-friendly.

INTERESTS IN PORTFOLIO COMPANIES

15. What forms of equity and debt interest are commonly taken by a private equity fund in a portfolio company? Are there any restrictions on the issue or transfer of shares by law? Do any withholding taxes or capital gains taxes apply?

Most common forms

Private equity (PE) funds commonly take securities or financial instruments in a portfolio company (that is not situated in Luxembourg but in the country of the target to be acquired by the PE or venture capital fund), which may carry specific financial or voting rights (such as preferred dividend rights). More complex and hybrid instruments can be used, depending on the financial arrangements and ultimate tax planning at investor level, which enable profit repatriation, capital gains or dividend flows in a tax efficient manner. The nature of certain hybrid instruments are currently being revised in the light of the OECD base erosion and profit shifting project (BEPS) as well as based on the Anti-Tax Avoidance Directive which should be implemented by 2019. As a general rule, a pure *Soparfi* can be financed up to 85% by debt, provided equity represents the remaining 15% of the company's total financing.

The issue or transfer of shares is subject to statutory legal requirements and the specific provisions of the company's articles of association. Generally, transfers or issues require approval by an extraordinary general meeting of shareholders (general meeting), or by the board for authorised capital.

Other forms

PE funds can take a preferred equity interest in an investee company. However, debt investments or a mix of preferred equity and debt are also common.

Restrictions

The legal restrictions on the transfer of shares depend on the type of company:

- **Private limited company (*société à responsabilité limitée*) (SARL).** An SARL's shares can be transferred to non-shareholders if a majority of the current shareholders, representing at least three-quarters of the corporate capital, agree to this in a general meeting. Specific clauses can also be included in the articles of association relating for example to pre-emption and rights of first refusal for the benefit of the remaining shareholders.
- **Partnership limited by shares (*société en commandite par actions*) (SCA) and public limited liability companies (*Société Anonyme)* (SA).** The general partner's and limited partners' shares of an SCA are freely transferable. An SA's shares are also freely transferable. Other provisions relating to restrictions on transfers, pre-emption and first-refusal rights are generally allowed, but are subject to certain restrictions, as a shareholder of an SA or SCA cannot be fully restricted from selling its shares.
- **Common limited partnerships (*société en commandite simple*) (SCS) and the special limited partnerships(*société en commandite special*) (SCSp).** The general partner's and limited partners' shares in an SCS or SCSp are generally not freely transferable. The conditions of transferability are usually provided in the limited partnership agreement.

Taxes

The potential payment of withholding tax and capital gains tax is assessed on a case-by-case basis; based on the specifics of the fund and the investor.

BUYOUTS

16. Is it common for buyouts of private companies to take place by auction? If so, which legislation and rules apply?

Auctions are common even for smaller and medium-sized buyouts. Most recent transactions for the acquisitions of financial services companies were done by auction. Auctions are not specifically regulated as such, but competition law is always considered.

17. Are buyouts of listed companies (public-to-private transactions) common? If so, which legislation and rules apply?

Buyouts of listed companies in Luxembourg are not common, as few companies have their shares (as opposed to debt instruments) listed on the regulated market of the Luxembourg stock exchange. Until recently, Luxembourg did not have specific legislation regulating takeover bids. The hostile takeover bid by Rotterdam-based Mittal Steel for steel producer Arcelor prompted the Luxembourg Government to implement Directive 2004/25/EC on takeover bids. As a result, security holders are now protected, and have enough time and information to allow them to reach a properly informed decision on the bid. In addition, new principles on mandatory offers, squeeze-outs, sell-outs and rights of withdrawal all regulate takeover bids and allow for better security for this type of transaction.

Principal documentation

18. What are the principal documents produced in a buyout?

Equity documents

These documents usually include:

- Letter of intent.
- Binding offer or memorandum of understanding.
- Confidentiality agreement.
- Share purchase agreement.
- Shareholder agreement.

- Amended and restated employment and service contracts.
- Documents relating to the guarantees concerning the purchase price payment and the satisfaction of potential liabilities (for example, in case of breach of a representation and warranty).

Financing documents

These documents usually include:

- Senior or mezzanine facility agreements.
- Security documents granting security over the shares and assets of the acquisition vehicle and the target.
- Inter-creditor agreement.

Buyer protection

19. What forms of contractual buyer protection do private equity funds commonly request from sellers and/or management? Are these contractual protections different for buyouts of listed companies (public-to-private transactions)?

Representations and indemnities

The most standard representations and warranties include the following:

- The organisation of the target and its ownership.
- The target's capitalisation (equity and shareholder debt, if any).
- Legal and regulatory compliance.
- The target's financial position (particularly the accuracy of the accounts on which the purchase price is based).
- Important contracts relating to the business of the target.
- Litigation.
- Employment.

Usually, warranty and indemnity protection are provided from both the seller in the sale and purchase agreement and management in the investment and shareholders agreement. If the seller is a PE fund, the scope of the representations and indemnity deal protection is more limited.

Purchase price adjustment

Lockbox arrangements are much less common since the financial crisis. Earn-out provisions are now the preference with a substantial part of the purchase price dependent on the target's financial performance after closing.

Information rights in favour of the sponsor

The sponsor is usually represented at the board of the target and also obtains (as a shareholder) regular reporting from management.

Management continuity

The fund can also require an undertaking from the target's management to remain in office for a minimum duration. Some service contracts (such as IT and accounting) can be extended for an agreed duration.

Exit

The articles of association of the target include the sponsor's rights to various exit routes, for example:

- IPO.
- Sale of all or part of the target.
- Liquidation.
- Merger.

20. What non-contractual duties do the portfolio company managers owe and to whom?

Non-contractual duties, such as duties of confidentiality and loyalty to the portfolio company, derive from general civil law obligations to act in good faith in the execution of any contract. These obligations are also usually set out contractually (common in employment contracts, but less common in the corporate mandate between the company's management body (managers or directors) and the company).

Managers with a corporate mandate must also exercise their mandate in line with the principles of good management, and act in the company's best interest.

21. What terms of employment are typically imposed on management by the private equity investor in an MBO?

A private equity investor typically imposes the following terms on management in an MBO:

- Exclusivity.
- Non-solicitation.
- Confidentiality.
- Non-competition clause.
- Management incentive plan with an economic return to management in line with the performance of the target.
- Good leaver or bad leaver rights and obligations for those managers leaving the target prior to an exit.

22. What measures are commonly used to give a private equity fund a level of management control over the activities of the portfolio company? Are such protections more likely to be given in the shareholders' agreement or company governance documents?

The measures depend on the outcome of negotiations between the fund and its management, and the legal rules regulating the target.

However, a fund typically requires from its portfolio company:

- Shareholder approval of some major decisions, stricter quorum rules, majority voting for some decisions and veto rights.
- The right to submit a list of candidates from which the shareholder meeting must choose a manager.
- Stricter quorum rules and majority requirements for board resolutions.
- The right to receive certain relevant information.
- The creation of internal committees in the portfolio company (right of information and consultation).

Whether these protections should be inserted in the articles of association or in a shareholder agreement is considered on a case-by-case basis.

The remuneration of key managers of the target or target group is usually tied to the performance of the target or target group with a management incentive plan often set-up as one of the various corporate vehicles.

DEBT FINANCING

23. What percentage of finance is typically provided by debt and what form does that debt financing usually take?

Financing by debt can come either from the investors (to benefit from the deduction of interest) or from third parties.

Investors' debt financing can take several forms, ranging from straightforward shareholder loans to hybrid, convertible or subordinated instruments. Interest paid to investors must be at arm's length. In addition, as far as holding activities are concerned, an 85:15 debt-to-equity ratio is generally regarded in practice as acceptable (other ratios may be acceptable provided the overall interest is not excessive). Interest limitation rules will come into play as from 2019 with the Anti-Tax Avoidance Directive which should be implemented in all EU member states.

Third party financings usually take the form of senior or mezzanine loans (syndicated or otherwise). Bond issues are also an option (parties enjoy a large degree of freedom in their terms and conditions) with bonds becoming very common for financings from EUR200 million for add-on and refinancing. Debt-to-EBITDA (earnings before interest, taxes, depreciation, and amortisation) ratios have been, in most cases in 2015 and 2016 around 7xEBITDA, with a general trend towards weaker covenants, larger credit lines and narrower pricing, although the European lenders have been more cautious than US lenders.

Lender protection

24. What forms of protection do debt providers typically use to protect their investments?

Protection for debt providers is regulated by the Law of 5 August 2005 on collateral arrangements, implementing Directive 2002/47/EC on financial collateral arrangements.

Security

Pledge of assets (*contrat de gage*). This is the most common way of taking security over Luxembourg assets. Pledge over shares or intra-group receivables and bank accounts are usually taken over all securities issued down to the target and certain members of the group. Ring-fencing is usually one notch below the fund and the management company set-up for the management incentive plan to ensure that the fund or management are not a party to the inter-creditor arrangements and, in the case of small PE funds, that the Alternative Investment Fund Managers Directive (AIFM Directive) thresholds are not reached. Depending on the business of the target or target group, a pledge over various items such as the business, IT rights and insurance contract rights will be granted in favour of third party lenders. Mortgages remain rare in the practice of leveraged finance deals.

Transfer of ownership by way of security interest (*transfert de propriété à titre de garantie*). This transfer can apply to the same assets as for a pledge of assets. On default, the transferor does not need to transfer ownership back, in accordance with the terms and conditions agreed in advance by the parties.

Contractual and structural mechanisms

Contractual subordination, acceleration and netting mechanisms are frequently used to secure investments.

Financial assistance

25. Are there rules preventing a company from giving financial assistance for the purpose of assisting a purchase of shares in the company? If so, how does this affect the ability of a target company in a buyout to give security to lenders? Are there exemptions and, if so, which are most commonly used in the context of private equity transactions?

Partnership limited by shares (*société en commandite par actions*) (SCA) and public limited liability companies (*Société Anonyme*) (SA). In principle, an SA or SCA can advance funds, make loans or provide security with a view to the acquisition of its shares by a third party, under the following conditions:

- Transactions must take place under the supervision of the board of directors or the management board (which must issue a specific report), and gain prior approval at a general meeting of shareholders.
- The transaction must be at fair market value, particularly in relation to interest received by the company and in relation to security provided to the company for the loans and advances.
- The credit standing of the third party must be duly investigated.
- The aggregate financial assistance granted must at no point result in the reduction of the net assets below the amount specified in the Luxembourg Act dated 10 August 1915 on commercial companies, as amended (Companies Act).
- The company must include a reserve in the liabilities in the balance sheet, which is unavailable for distribution, of the total amount of the financial assistance.

However, this rule does not apply to the acquisition of shares by, or for, the company's employees.

Private limited company (*société à responsabilité limitée*) (SARL), common limited partnership (*société en commandite simple*) (SCS) and the special limited partnership (*société en commandite special*) (SCSp). The above rules do not apply.

Insolvent liquidation

26. What is the order of priority on insolvent liquidation?

Insolvency procedures are regulated by law, notably the:

- Commercial and Civil Codes.
- The Law of 24 May 1989 relating to employment contracts.
- The Law of 5 August 2005 on collateral arrangements and Regulation (EC) No 1346/2000 on insolvency proceedings.

All creditors, other than secured and privileged creditors, must be treated equally. Payments to secured and privileged creditors are made in the following order:

- The receiver's fees and the liquidation expenses.
- Privileged claims, for example, money owed to employees, certain social security contributions and outstanding taxes.
- Payment of the lower ranking privileges and secured creditors.

However, pledges and transfers of ownership through security interest remain valid and fully enforceable, despite the start of insolvency proceedings against the grantor, to the extent they apply to financial instruments (including all types of securities) or receivables (including those resulting from bank accounts), as well as netting arrangements. Secured assets covered by these security interests are, therefore, not included in the assets available for distribution to the general pool of creditors.

Shareholders' capital contributions are only repaid if and when all other creditors have been fully satisfied.

Equity appreciation

27. Can a debt holder achieve equity appreciation through conversion features such as rights, warrants or options?

It is possible, and common in some circumstances, for debt holders to achieve equity appreciation through using conversion features on convertible debt instruments, warrants and/or options.

Typically such instruments are highly subordinated and have a lower interest rate, as their remuneration or appreciation is embedded in the conversion feature. Through the conversion feature, the instrument appreciates in value according to the appreciation of the shares into which the instrument is convertible. The law permits high legal flexibility for the design of these instruments, combined with extensive administrative tax practice. It is advisable to confirm the tax treatment with the Luxembourg direct tax authorities depending on the circumstances.

PORTFOLIO COMPANY MANAGEMENT

28. What management incentives are most commonly used to encourage portfolio company management to produce healthy income returns and facilitate a successful exit from a private equity transaction?

There is no specific legislation regulating management incentives. Share options are most commonly used to encourage management to be involved in the company's development, since they can benefit from favourable tax treatment in certain circumstances (*see Question 29*).

The following are also used:

- Share purchase plans.
- Phantom share plans.
- Other types of bonus schemes linked to the company's results.

Ratchets are used and their mechanism is defined contractually, as they are not regulated and can take different forms.

29. Are any tax reliefs or incentives available to portfolio company managers investing in their company?

Share options are most commonly granted to encourage management to be involved in the company's development, as they may benefit from favourable tax treatment in certain circumstances.

On 20 December 2012, the tax authorities issued a new circular (LIR 104/02) on the taxation of stock option plans granted to employees. This circular applies from 1 January 2013 and replaces the old circular from 11 January 2002.

A promise made by the employer to the employee that he will receive a benefit under certain conditions is not taxable employment income (it only becomes taxable for the employee when the asset is put at the disposal of the employee). Therefore, a distinction is made between a transferable and non-transferable stock option.

Generally, capital gains on the disposal of options or shares are taxable as extraordinary income (*Articles 99bis and 100, LIR*). The calculation of the taxable basis (that is, the gain) differs depending on the transferability features of the options or shares.

30. Are there any restrictions on dividends, interest payments and other payments by a portfolio company to its investors?

Article 30 of the AIFMD provides (subject to certain exceptions) limitations on distributions, capital reductions, share redemptions or purchases of own shares by a private or public portfolio company during the first two years of ownership by a private equity fund managed by an AIFM. Although drawn from European company law applicable to public companies, the restrictions under Article 30 of the AIFMD apply to private as well as public companies owned by private equity funds, and are therefore more burdensome than the regulatory regimes in place in many EU member states at the moment.

The AIFM:

- Must not "facilitate, support or instruct" any of the prohibited actions.
- Cannot vote in favour of the prohibited actions.
- Must use "best efforts" to prevent the prohibited actions.

Therefore, the acquisition structure considers these restrictions, to accommodate necessary cashflow to upstream in light of the overall transaction, with equity/quasi-equity financing by the sponsor (for example, repayment of loan notes is not covered by the Article 30 provisions, so if an investment is structured by way of loan notes the Article 30 restrictions would not apply).

Further, interim and annual dividends require distributable reserves. *Soparfis* must retain a legal reserve of 5% of the yearly profit, up to an amount of 10% of the share capital of the company.

There are no other restrictions on interim dividend distributions for limited liability companies or private limited company (*société à responsabilité limitée*). Partnership limited by shares (*société en commandite par actions*) and public limited liability companies (*société anonyme*) can only distribute interim dividends in certain circumstances, and if their articles of association allow this.

Distribution of dividends is generally subject to a 15% withholding tax, unless the rate is reduced (even to nil) by a:

- Double tax treaty or the rules implementing the Parent Subsidiary Directive (which have been extended and adapted to dividend distributions).
- Funding instrument allowing repatriation of the profits free of withholding tax (*see Question 27*).

There is no withholding tax on liquidation proceeds or on interest payments (except in specific circumstances) (*see Question 5*).

31. What anti-corruption/anti-bribery protections are typically included in investment documents? What local law penalties apply to fund executives who are directors if the portfolio company or its agents are found guilty under applicable anti-corruption or anti-bribery laws?

Anti-corruption provisions are usually included in the warranties and restrictive covenants of the acquisition agreement. In addition, it is increasingly common to include principles of good governance into the rules of procedure for the management.

In general, it is prohibited to corruptly solicit, receive, promise or offer any gift, reward or other advantage, whether directly or indirectly, as an inducement to a person to do or forbear from doing anything (*Articles 246 and 247, Luxembourg Criminal Code*).

Active and passive corruption in the private sector is punishable, for natural persons, by one month's to five years' imprisonment and a fine (*Article 36, Luxembourg Criminal Code*).

EXIT STRATEGIES

32. What forms of exit are typically used to realise a private equity fund's investment in a successful company? What are the relative advantages and disadvantages of each?

Forms of exit

Trade sales and secondary buyouts remain the most common form of exit. The form of exit used mainly depends on:

- The form of the corporate vehicle.
- Where the portfolio company is located.
- The contractual and commercial reasons for the exit.

With corporate vehicles, an exit (full or partial) can be made through the following ways, or a combination of all or some of them:

- Redemption of the funding or debt instruments.
- Redemption of shares.
- Voluntary liquidation of the corporate vehicle.
- Distribution of dividends. This is used less frequently as it is generally subject to withholding tax (*see Question 5*and*Question 30*).

33. What forms of exit are typically used to end the private equity fund's investment in an unsuccessful/distressed company? What are the relative advantages and disadvantages of each?

Forms of exit

In most cases, the form of exit from an unsuccessful portfolio company depends on the foreign law applicable to that company. The usual forms of exit are the sale to another buy-out fund or to the management. An asset sale is rarer in practice, as is an insolvent exit. However, a voluntary winding-up is most likely to be the preferred exit of the Luxembourg holding vehicle. In some cases, the bankruptcy rules can also apply.

Advantages and disadvantages

There are no particular advantages or disadvantages to the different methods. Liquidation should not trigger any adverse legal, in particular tax, consequences (*see Question 5*).

PRIVATE EQUITY/VENTURE CAPITAL ASSOCIATIONS

Luxembourg Private Equity and Venture Capital Association (LPEA)

W *www.lpea.lu*

Description. The LPEA represents, promotes and protects the interests of the Luxembourg private equity and venture capital industry.

The Association of the Luxembourg Fund Industry (ALFI)

W *www.alfi.lu*

Description. ALFI is the official representative body for the Luxembourg investment fund industry.

Invest Europe Association formerly European Private Equity and Venture Capital Association (EVCA)

W *www.evca.eu*

Description. EVCA is the representative body for the European private equity industry.

ONLINE RESOURCES

Luxembourg Commission for the Supervision of the Financial Sector's (Commission de Surveillance du Secteur Financier) (CSSF)

W *www.cssf.lu*

Description. This is the website of the Luxembourg financial supervisory authority. Laws and regulations are generally accessible in French and English. English translations are not binding.

Luxembourg Private Equity and Venture Capital Association (LPEA)

W *www.lpea.lu*

Description. The LPEA represents, promotes and protects the interests of the Luxembourg private equity and venture capital industry.

The Association of the Luxembourg Fund Industry (ALFI)

W *www.alfi.lu*

Description. ALFI is the official representative body for the Luxembourg investment fund industry.

Invest Europe Association formerly European Private Equity and Venture Capital Association (EVCA)

W *www.evca.eu*

Description. EVCA is the representative body for the European private equity industry.

Direct tax authorities (Administration des Contributions Directes)

W *www.impotsdirects.public.lu*

Description. This is the website of the Luxembourg direct tax authorities.

Indirect tax authorities (Administration de l'Enregistrement et des Domaines)

W *www.aed.public.lu*

Description. This is the website of Luxembourg indirect tax authorities.

Practical Law Contributor profile

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